MORRISON | FOERSTER

2000 PENNSYLVANIA AVE., NW
WASHINGTON, D.C.
20006-1888

TELEPHONE: 202.887.1500
FACSIMILE: 202.887.0763

WWW.MOFO.COM

MORRISON & FOERSTER LLP
NEW YORK, SAN FRANCISCO,
LOS ANGELES, PALO ALTO,
SAN DIEGO, WASHINGTON, D.C.
NORTHERN VIRGINIA, DENVER,
SACRAMENTO, WALNUT CREEK
TOKYO, LONDON, BRUSSELS,
BEIJING, SHANGHAI, HONG KONG

Writer's Direct Contact
202.887.1566
LFischer@mofo.com

April 14, 2010

By Electronic Delivery

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Docket No. R-1384

Re: Proposed Rule on CARD Act Requirements Effective August 22, 2010

Dear Ms. Johnson:

This comment letter is submitted by Morrison & Foerster LLP on behalf of several credit card issuers in response to the proposed rule ("Proposed Rule" or "Rule") issued by the Federal Reserve Board ("Board") to implement the "Credit Card Accountability Responsibility and Disclosure Act of 2009" (the "CARD Act" or "Act"). The Proposed Rule implements provisions of the CARD Act that are scheduled to become effective on August 22, 2010. We appreciate the opportunity to comment on this important matter.

MANDATORY COMPLIANCE DATE

Notwithstanding the effective date of the final rule adopted by the Board, it is essential that issuers be provided adequate time to implement the requirements contained in the final rule. For all practical purposes, if the final rule is similar to the Proposed Rule, it will require a complete transformation of the existing penalty fee structure for the entire credit card industry. The Proposed Rule also would require modification of a number of disclosure documents, including disclosures on applications and solicitations, account-opening forms, periodic statements and change in terms notices. As a result, issuers will yet again be required to review and restructure their credit card portfolios, underwriting criteria and credit models to comply with the Rule. In addition, issuers will be required to make additional revisions to disclosures, credit agreements and operations less than 60 days after July 1, 2010, the effective date of other extensive and costly amendments to the Truth in Lending Act and Regulation Z.

Given the sweeping nature of the proposed changes and the likelihood that there will be limited time between publication of the final rule and the August 22, 2010 effective date, we strongly recommend that the Board adopt a mandatory compliance date that is no earlier than 180 days after the publication of the final rule in the *Federal Register*. A mandatory compliance date that is at least 180 days following the issuance of a final rule is consistent with the Congressional directives in the CARD Act. That is, the CARD Act directed the Board to issue a final rule no later than February 22, 2010, which would have given issuers approximately 180 days to comply with resulting new regulations. Accordingly, consistent with the CARD Act, we believe the Board could make the effective date of the final rule August 22, 2010 and the mandatory compliance date at least 180 days after the issuance of the final rule so that issuers will have adequate time to implement the extensive legal and compliance obligations mandated by the Rule and to convert these new obligations into disclosures and policies that are compliant with the Rule. If the Board determines not to provide such a 180-day mandatory compliance date, then the Board should accelerate the release of the final version of the final rule to provide as much time for compliance as possible.

In addition, at a minimum, it is essential that the Board make two important clarifications. First, it is important that the Board include a clear statement in the text of the regulation or commentary itself clarifying that there is no notice requirement necessary for any reduction in a penalty fee, even if the way in which the fee is determined or calculated will change. That is, a change in how the fee is determined (*i.e.*, a percentage of the required minimum payment) should not require an issuer to provide any notice if the amount of the fee is being reduced. Second, in recognition of the inadequate time an issuer will have to revise account-opening disclosures and other related disclosures to reflect fee reductions and related changes, it is essential for the Board to include implementation guidance clarifying that for a reasonable period of time an issuer can continue to use existing disclosure forms that include higher penalty fees so long as the issuer complies with the fee restrictions contained in the final rule and any penalty fee or fees imposed by the issuer are equal to or less than the fee(s) included in those disclosure forms. Given the compressed compliance time frame, it simply will not be possible for issuers to substitute new disclosures prior to the effective date, particularly at branches and point-of-sale locations.

LIMITATIONS ON PENALTY FEES (SECTION 226.52)

Reasonable and Proportional Standards

As proposed, the standards for determining whether a penalty fee is reasonable and proportional to the violation are inconsistent with the CARD Act and will significantly reduce an issuer's ability to recoup its actual costs incurred as a result of the violation. Specifically, Section 226.52(b) as proposed purports to implement the CARD Act provision prohibiting an issuer from imposing a penalty fee or charge in connection with a violation of a credit agreement unless the penalty fee is "reasonable and proportional" to the violation. Section 102 of the CARD Act directed the Board, in establishing standards for implementing the requirements of

the Section, to consider the costs incurred by an issuer, the deterrence of violations by the consumer, the conduct of the consumer and other factors deemed necessary or appropriate. Instead of looking at conduct and other relevant factors, the Proposed Rule would require an issuer to justify its penalty fee structure based on only one of the first two factors or to accept a safe harbor fee established by the Board. Moreover, the standards for the two factors established in the Proposed Rule are unworkable and cannot be used by issuers to set penalty fee amounts. As a result, the Proposed Rule goes well beyond the statute and would establish price controls, and in many cases, the specific prices for penalty fees.

As discussed below, because the vast majority of issuers would not be able to use the proposed alternative standards for determining the "total" costs incurred or to deter violations, most issuers will, by default, be forced to use the proposed safe harbor penalty fee amounts, unless the safe harbor amounts exceed both the cost of administering penalty fees and the amount necessary to reasonably deter late payments and other account violations. Accordingly, consistent with the CARD Act, we strongly recommend that the Board, in consultation with other agencies, amend the Proposed Rule to establish standards that not only reflect the actual total costs incurred as a result of a violation, but also are sufficient to deter such violations.

Safe harbor

The Proposed Rule includes a safe harbor provision that would permit issuers to impose penalty fee amounts established by the Board, but still would permit a higher penalty fee amount under certain circumstances where the "amount associated with the violation" is larger. Specifically, an issuer would be deemed to have complied with the reasonable and proportional penalty fee requirement if the dollar amount of the penalty fee does not exceed the greater of: (1) a specific dollar amount set by the Board (which has yet to be established); or (2) five percent of the dollar amount associated with the violation, provided the dollar amount does not exceed an upper dollar amount set by the Board (which also has yet to be established).

The Board has requested commenters to submit data concerning the safe harbor amounts. In particular, the Board requested that issuers submit data regarding the costs incurred as a result of a particular type of violation and the dollar amounts reasonably necessary to deter violations, as well as the methods used to determine those amounts. The industry is in the process of compiling and evaluating such information. This comment letter will not attempt to discuss such findings nor will it provide suggestions relating to the specific dollar amounts that should be used for the lower and upper safe harbor limits to be determined by the Board; instead, we will leave the reporting of those findings to the comment letters of those currently engaged in that analysis.

Nevertheless, we have comments on the general safe harbor approach and the method used to determine the safe harbor amount – that is, the amount associated with the violation. First, the Proposed Rule indicates that the dollar amount associated with a late payment or a returned payment is the required minimum periodic payment, rather than the account balance or the amount of the returned payment. For example, under the proposed safe harbor, if the

required minimum periodic payment is $50, such a restriction arguably would only permit the imposition of a late fee that is the greater of the safe harbor amount or $2.50.

We believe that the amount associated with the violation should not be the required minimum periodic payment; instead, the amount associated with the violation should be the full account balance. That is, the consumer is required to repay the full account balance under the terms specified in the credit agreement. Thus, if the consumer does not repay the account balance as required under the terms of the agreement, the dollar amount at risk is the dollar amount associated with the failure to pay the account balance, rather than the required minimum periodic payment.

Prohibited fees

Tying the amount of the violation to the required minimum payment is especially problematic in the context of the fee prohibition included in the Proposed Rule. That is, the Proposed Rule would prohibit penalty fees that exceed the dollar amount associated with a violation. For example, if a consumer has a required minimum payment of $15, an issuer would be prohibited from charging a returned check fee that exceeds $15, even though the issuer's costs incurred in connection with such a returned check far exceed $15.

Similarly, under the Proposed Rule, an issuer would be prohibited from imposing a fee in connection with transactions that the card issuer declines to authorize. Prohibiting an issuer from imposing a fee for declining a transaction may be understandable in the context of a point-of-sale transaction; however, the Board should distinguish between declinations at the point of sale and declinations in connection with convenience checks or similar instruments. That is, the Board should not prohibit an issuer from assessing a penalty fee for the return of a convenience check where there is no available credit or when the convenience check has expired, because issuers frequently incur costs for the return of such instruments similar to the costs incurred in connection with returned checks.

The Board acknowledges in the supplemental information accompanying the Proposed Rule that an issuer may incur greater costs as a result of the Proposed Rule. While the Board suggests that an issuer may recoup these costs by spreading them evenly among all other consumers by charging higher upfront costs, we believe that this result is unfair to consumers who make payments in accordance with their account terms. That is, consumers who are making timely payments should not have to subsidize the cost of credit for those consumers choosing to violate the terms of their accounts by making late payments or using convenience checks after engaging in other transactions that delete their available credit.

Costs incurred as a result of violation

The Proposed Rule would permit an issuer to "impose a [penalty] fee for violating the terms or other requirements of an account if the card issuer has determined that the dollar amount of the [penalty] fee represents a reasonable proportion of the total costs incurred by the card issuer as a result of that type of violation."

Nevertheless, even though the Board acknowledges in the supplemental information accompanying the Proposed Rule that higher rates of loss may be associated with particular violations, the Proposed Rule would not permit an issuer to include any portion of the losses incurred by the issuers as a result of such violations or the costs associated with holding reserves against such losses when the issuer makes its cost analysis. In other words, the Board states that an issuer should be able to consider its "total costs," and then prohibits the issuer from considering two of the principal elements of its total costs. Therefore, we strongly urge the Board to reconsider the prohibition against including the costs related to losses and loss reserves, or at least a portion of these costs, in an issuer's cost analysis. Even if losses are included as part of an issuer's cost analysis, the other prohibitions contained in the Rule will ensure that the resulting fees are reasonable and proportional to the violation. For example, even if an issuer is permitted to include losses in its cost analysis, consumers still would be protected by the prohibition against imposing a penalty fee that exceeds the amount associated with the violation. For instance, even if a late fee of $25 could be justified pursuant to an issuer's cost analysis, an issuer could not impose that late fee if the required minimum payment were lower than $25.

Without the ability to consider losses, actual and significant costs incurred in connection with certain violations of the credit agreement, such as the loss of principal, carrying cost of a non-performing loan and interest foregone, will not be reflected in the issuer's cost calculations. Thus, the penalty fee amount will not accurately reflect the true costs incurred in connection with certain types of violations and issuers will incur costs that exceed the penalty fee amounts. As a result, as acknowledged in the supplemental information, "the proposed limitation...may encourage card issuers ... to build costs into upfront rates and fees." This approach would be necessary because the repricing limitations under section 226.55 of Regulation Z prohibit an issuer from imposing rate increases on an outstanding balance. Therefore, in order to recoup total costs incurred, an issuer will be forced to increase rates on new and existing accounts. For existing accounts, such an increase could effectively require an issuer to reevaluate rate increases on an account for an indefinite period of time because, under these circumstances, it is unlikely that the issuer will ever return rates to those applicable prior to the increase. We, therefore, recommend that the Board revise the Rule to permit issuers to factor in some portion of costs related to their actual losses resulting from such violations and the reserves that must be maintained in anticipation of those losses.

In addition, the Proposed Rule would require an issuer to either make its own determination based on its own independent experience concerning whether the dollar amount of a penalty fee represents a reasonable and proportional amount of the total costs incurred by that issuer or rely on the safe harbor amount specified in the Rule. We recommend that the Board establish a safe harbor amount that factors in the actual total costs incurred by issuers. If the Board fails to do so, it is critically important that the Proposed Rule be revised to clarify that while an issuer must make an independent determination of whether a specific dollar amount is reasonable and proportional, an issuer is permitted to use industry standards regarding the nature and amount of the costs caused by various types of violations when making its determination that its own penalty fees are reasonable and proportional. Specifically, the costs incurred standard

should be modified to allow an issuer to use any reliable information that is available to the issuer concerning the costs of certain violations. This is especially important when the issuer does not currently have data on such costs, for example, in connection with a new account offering or when changing to a new service provider. It also is important for smaller issuers and new entrants to the marketplace. Without these modifications, most issuers will not be able to utilize the proposed cost standard and, instead, will be forced to use the safe harbor price fixed by the Board under the Rule.

Deterrence of violation

As an alternative, the Proposed Rule would permit an issuer to "impose a [penalty] fee for violating the terms or other requirements of an account if the card issuer has determined that the dollar amount of the [penalty] fee is reasonably necessary to deter that type of violation using an empirically derived, demonstrably and statistically sound model that reasonably estimates the effect of the amount of the [penalty] fee on the frequency of violations."

There are significant problems with the deterrence standard as proposed in the Rule. First, the proposed standard is problematic because of the stringent conditions (*i.e.*, independent of other variables, the imposition of a lower fee would result in an increase in violations) that would be required for determining whether a particular penalty fee is necessary to deter violations. Such conditions could make it difficult, if not impossible, for an issuer to use the proposed deterrence standard as a basis for establishing the amount of a penalty fee, especially by the August 22, 2010 effective date.

For instance, the Proposed Rule states that "[a] model that reasonably estimates a statistical correlation between the imposition of a [penalty] fee and the frequency of a type of violation" does not satisfy the requirement. Instead, "a model must reasonably estimate that, independent of other variables, the imposition of a lower [penalty] fee amount would result in a substantial increase in the frequency of that type of violation." To meet this standard, an issuer would be required to test the effect of penalty fee amounts that are lower and higher than the amount ultimately found to be reasonably necessary to deter a type of violation. For most issuers, it will be difficult, if not impossible, to gather the necessary data by the August 22, 2010 effective date. In this regard, the Proposed Rule states that if an issuer cannot complete deterrence testing prior to the effective date, the issuer must assess penalty fees based on costs incurred by the issuer or on the safe harbor discussed below. Thus, under the proposal, if an issuer cannot complete the deterrence testing before the August 22, 2010 effective date, the issuer would effectively be precluded from ever testing higher penalties fees because such amounts may not fall within the safe harbor limits.

Second, because preliminary testing appears to indicate that penalty fees currently being imposed may not be high enough to effectively deter consumers from violating the terms of the agreement, it is critically important for issuers to have a reasonable opportunity to test higher fees in order to be able to establish and justify reasonable deterrent amounts. Consistent with the CARD Act, which instructs the Board to consider deterrence as one of the factors that should be

used to determine whether a fee is reasonable and proportional, the Board should amend the Rule so that issuers are able to actually use the deterrence factor to establish penalty fee amounts.

Consumer conduct

The Proposed Rule would not require an issuer to base its calculation of a reasonable penalty fee on the conduct of, or the costs caused by, an individual consumer. The Board explains that the Proposed Rule would take into account consumer conduct "generally" by permitting an issuer to impose a penalty fee reasonably necessary to deter a certain type of violation but, as spelled out in the supplemental information accompanying the Proposed Rule, "would not permit penalty fees to be based exclusively on consumer conduct."

While from an operational standpoint it may not be feasible for an issuer to factor in specific consumer conduct in all instances, there may well be circumstances where imposing fees based on specific conduct would be warranted. Accordingly, we recommend that the Board allow issuers to factor in specific consumer conduct, especially in connection with repeated violations by that consumer of the same type.

At a minimum, the Board should clarify that the overall amount associated with repeated violations can be considered as the amount associated with the violation. For example, if a consumer has not made two consecutive required minimum periodic payments, the Rule should make it clear that an issuer is permitted to use the total of the required minimum periodic payments for two consecutive cycles as the amount associated with the violation for purposes of calculating the percentage of the late fee, even if a late fee was imposed in the prior cycle.

Disclosures—account opening, change in terms notices and periodic statements

Under the Proposed Rule, an issuer would be required to revise application, account opening, and periodic statement disclosures relating to the amount of any late fee or other penalty fee. Specifically, the Proposed Rule would permit an issuer to disclose either a range of penalty fees or an "up to" amount. There are several important clarifications necessary regarding the "up to" disclosure requirement, including:

- Clarification that the imposition of a lower penalty fee or the waiver of a penalty fee would not trigger a 45-day advance notice of the right to reject upon the subsequent imposition of a penalty fee that is within the "up to" amount disclosed to the consumer;
- Clarification regarding the use of a percentage of the minimum payment for the late fee. Specifically, the Board should clarify that the late payment warning display of the maximum late payment fee is a static disclosure, rather than a variable field. For example, an issuer would not be required to display the actual late payment fee associated with a particular billing cycle based on the percent of the minimum payment;

- Clarification that a partial payment does not require an issuer to adjust the calculation of the "amount of the violation." For example, for late payment purposes, the percentage of the required minimum periodic payment can be used notwithstanding the receipt of a partial payment on the account. In this regard, at the time the late fee is imposed the issuer likely will not know that a partial payment has been or will be made.

Reevaluation of penalty fees

As noted above, while an issuer will not be able to reevaluate deterrence costs, the Proposed Rule also would require an issuer to reevaluate its cost or deterrence determination at least once every 12 months. And, if an issuer determines that a penalty fee should be lower, the issuer must begin imposing the lower penalty fee within 30 days after completing its reevaluation. In contrast, if an issuer determines that a penalty fee should be higher, the issuer must comply with the 45-day advance notice requirements before imposing the higher fee.

In addition, the application of the 45-day advance notice requirements suggests that an issuer might be required to provide the consumer with the ability to reject a fee increase. Since penalty fee increases will have to be based either on costs incurred by the issuer or deterrence of the particular account violation, the Board should clarify that the right to reject does not apply in this context by amending the requirements to expressly exempt penalty fee increases pursuant to cost or deterrence determinations. Application of the right to reject to increases based on an issuer's annual reevaluation is inappropriate because it interferes with the ability of an issuer to make adjustments in fees that would otherwise be permitted under the Rule.

In any event, the Rule should clarify that neither the 45-day notice nor the right to reject is required for annual adjustments in the safe harbor number to reflect changes in the Consumer Price Index.

REEVALUATION OF RATE INCREASES (PROPOSED SECTION 226.59)

Proposed Section 226.59 implements the CARD Act provision requiring an issuer who increases the rate on an account based on risk factors to consider changes in "such factors" when subsequently determining whether to reduce the rate on that account. Specifically, an issuer will be required to review, every six months, any account where the rate has been increased since January 1, 2009. The CARD Act expressly states that this provision should "not be construed to require a reduction in any specific amount."

We applaud the Board for not proposing rigid standards that an issuer must consider in connection with reevaluating a rate increase. Rigid standards establishing specific factors an issuer must include or exclude would constrain an issuer's ability to establish underwriting standards that could ultimately prove beneficial to consumers. Moreover, we strongly support the Board's acknowledgement that the factors used to implement a rate increase may be out of date at the time of the reevaluation. And, thus, we support the clarification in the Proposed Rule than an issuer would not be required "to base its review . . . on the same factors on which a rate

increase was based." Instead, an issuer would be permitted to "review either the same factors on which the rate increase was originally based, or to review the factors that it currently considers when determining the [rate] applicable" to the account. A review of the current factors would effectively result in the consumer receiving any reduced rate that he or she would receive if applying for a new account.

Nevertheless, the Proposed Rule could be interpreted to require an issuer to review an account with a rate increase until the issuer reduces the rate to a rate applicable to the account immediately prior to the increase, subject to changes in the applicable index. We recommend that the Board specifically limit how long an issuer is required to review an account to avoid a potentially indefinite obligation to reevaluate an account every six months. Without the establishment of some limitations, it is possible that an issuer would have to review an account for 20 or 30 years, for example. Instead, we recommend that the Board amend the Rule to permit an issuer to cease reviewing a rate increase when the rate is at the level it would be if the consumer were a new customer subject to a review of the issuer's current factors, including, but not limited to, the creditor's experiences with that particular consumer as a customer. In addition, the Rule should make it clear that an issuer can make this determination on a product-by-product basis, because the risk factors of products can vary greatly. This approach is consistent with the Rule that permits an issuer to review current factors, and could benefit consumers and issuers alike by encouraging issuers to more quickly implement rate reductions so that issuers can cease to reevaluate rate increases. As an alternative to the limitation mentioned above, we recommend that the Board amend the Rule to limit an issuer's duty to reevaluate a rate increase to a period of no more than three years; thus, an issuer would only have to perform six such reviews for any account.

The Proposed Rule also addresses the application of the proposed requirement to acquired credit card portfolios. With some exceptions, the obligation to review risk changes would be applicable to accounts that an issuer acquires. Nevertheless, under the Proposed Rule, an issuer would be permitted to use the factors that the issuer itself currently considers in determining the rates applicable to its own accounts. We support this essential flexibility, since it is unlikely that issuers will have sufficient information about the selling issuer's pricing practices to do otherwise; however, the issuer should be able to make this determination on a product-by-product basis.

We also support the clarification under the Proposed Rule that the reevaluation requirement only applies to rate increases for which 45 days' advance notice is required; and support the inclusion of two exceptions to the reevaluation requirement. The first exception applies to rate increases following a rate reduction pursuant to the Servicemembers Civil Relief Act, although it is important that comparable state laws be similarly addressed. The second exception applies to rate increases in connection with charged off accounts. In addition, the Proposed Rule would not require an issuer to review a rate increase pursuant to a 60-day delinquency prior to the expiration of the six-month cure period and then only if the rate has not been decreased.

In addition, we recommend that the Board amend the Rule to provide an exception for a rate increase resulting from the loss of a promotional rate. The loss of a promotional rate is not based on the type of factors, such as credit risk and market conditions, that an issuer typically considers in connection with rate increases on an entire portfolio or to a certain class of accounts. Rather, a rate increase based on the loss of a promotional rate is a contractual determination. That is, under the terms of the promotion, an issuer is only eligible for the promotional rate if the consumer is making timely payments. In this regard, an issuer does not consider specific factors as part of the rate increase; rather, the rate increase is pursuant to the terms of the promotional offer and failure to comply with these terms results in the loss of a promotional rate. Accordingly, the requirement to review such rate increases should not apply in this context.

Proposed Section 226.59(a)(2) states that if a card issuer is required to reduce the rate applicable to an account pursuant to § 226.59(a)(1), the card issuer must reduce the rate no later than 30 days after completion of its evaluation. In the context of a rate reduction, the Proposed Rule is not clear concerning the application of the reduced rate. Consistent with the requirement that a rate increase be prospective and for ease of compliance, an issuer should be permitted to apply the reduced rate to the following balances, as appropriate: (1) new transactions only; (2) outstanding balances that were subject to the rate increase reevaluation; or (3) new transactions and outstanding balances that were subject to the rate increase reevaluation. Requiring the reduction to apply to all outstanding balances that were subject to the rate increase would be operationally difficult to implement.

If you have any questions regarding these comments, please contact me, at (202) 887-1566.

Sincerely,

L. Richard Fischer